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Taking a Fresh Look at Informal Finance

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During the past several years I have often been asked to name sustainable agricultural credit programs in low-income countries (LICs). Answering these requests causes me embarrassment, disappointment, surprise, amazement, and puzzlement. My embarrassment comes from being able to name so few sustainable programs, despite the tens of billions of dollars committed to hundreds of these efforts. At the same time, I painfully remember large numbers of transitory credit activities that have been plagued by loan recovery problems, chronic dependency on outside funds, and excessive transaction costs. My disappointment stems from seeing little improvement in the performance of these efforts since the mid-1960s when Ohio State University began working on problems of rural financial markets (RFMs).[2] While our understanding of how

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[1]Many of the ideas in this paper have been gleaned from others who have burrowed more deeply into informal finance than have I. Frits Bouman and Clifton Barton gave me lectures years ago about the importance of informal finance that I am only now beginning to appreciate fully. J. D. Von Pischke, Robert Vogel, and colleagues at Ohio State University have done much of the research and original thinking on which I base my paper. Two anthropologists, Marie Canavesi and Virginia Sandoval, also exposed me to informal finance in Bolivia and the Philippines. I also learned a great deal about informal finance while attending an excellent seminar in the Philippines in early 1989 sponsored by the Asian Development Bank and organized by P.B. Ghate. The references at the end of the paper identify other individuals who have unwittingly influenced my thinking on this topic.

[2]This work was funded by the Agency for International Development (AID) and has involved research in more than three dozen low-income countries. The steady support of our work by numerous AID employees over the years is a proxy for the frustration many of them harbor about rural credit projects.

RFMs function and what causes them to misfire has expanded substantially in the past two decades, only in a handful of cases has this new knowledge been used to treat RFM ills.[3] I have grudgingly concluded that creating sustainable rural credit programs is far more difficult to do than most of us had heretofore thought.

My embarrassment and disappointment are tempered by _surprise_. In recent research in Bolivia and the Philippines--two countries suffering substantial economic stress--I encountered informal finance thriving amidst the rubble of formal financial markets.[4] It surprised me to see informal lenders recovering most of their loans while nearby formal lenders were awash in defaults, and I marveled at the ability of informal finance to mobilize and allocate large amounts of voluntary savings, while banks attracted relatively few deposits.[5]

My _amazement_ arises from the contrast in the types of people served by formal and informal finance along with the differences in types of services provided. Formal finance typically involves large loans and deposits, secure collateral, relatively long-term financial instruments, and legal backing. Formal finance also services mostly individuals who are the crème de la crème but who are required to come to the financial institution to transact their

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[3]Readers interested in further details on the problems in rural financial markets as well as in the new views on how to resolve some of these problems might refer to the volumes by Donald and by Adams, Graham, and Von Pischke cited at the end of the paper.

[4]The various terms used in the literature to categorize financial markets include _institutional_ and _noninstitutional_, _organized_ and _unorganized_, _regulated_ and _nonregulated_, _commercial_ and _noncommercial_, _production_ and _consumption_, and _formal_ and _informal_. I feel more comfortable with the latter two terms and use the term _formal_ to mean all financial transactions that are supervised, regulated, and monitored by some central financial or monetary authority. The term _informal finance_ encompasses all other financial activities in an economy.

[5]Tuck reports similar conditions in Senegal in the early 1980s.

business. In contrast, informal finance frequently involves small loans and deposits, commonly functions without collateral, typically deals with short-term transactions, and often operates in the legal shadows. Many participants in the informal system are poor people, women, operators of small businesses, small farmers, and the landless--people who are often unable to obtain formal financial services. Unlike the formal financial system, transactions in informal finance usually occur at the doorstep of clients, at their place of work, or in popular markets. I am amazed that informal finance can provide these services to the people it does without choking on expenses and drowning in defaults. Like the aeronautical engineers who have analyzed bees and concluded they should not be able to fly, I am convinced that informal finance defies the laws of financial gravity.

Further, I am puzzled by the ability of informal finance to provide sustained financial services to large numbers of individuals who have been targets of temporary or sporadic formal credit programs. These formal credit efforts are usually staffed by educated people who receive extensive technical assistance from both donors and governments along with ample access to both subsidies and concessionary funds. Even with these advantages, formal rural credit efforts often founder, while informal finance, which enjoys none of these advantages, typically flourishes. Success in financial transactions appears to be inversely related to years of education of the participants, technical assistance received, access to concessionary funds, and extent of regulation! This raises two important questions: Why do formal agricultural credit programs so often fail? And, why do informal financial activities so often succeed? Space limitations oblige me to deal mainly with the latter question here.

Traditional Views About Informal Finance

Informal forms of lending—particularly moneylenders—are stereotyped as being evil in many cultures. Poets, prophets, playwrights, and politicians have pointed accusing fingers at informal lenders and questioned the comfort of their after-life since the beginning of recorded history. Individuals as diverse as Cicero, Shelley, Shakespeare, Marx, the Prophet Mohammed, and writers of the Old Testament have vented their spleens on the supposed evils of money lending. Pejorative and emotive terms such as monopolist, usurer, shylock, loan shark, and exploiter color discussions of this topic. I know of no other area in development where anecdotal horror stories are told and retold so often to nurture traditional views (Nelson). For my tastes, too many discussions of informal lending include racial and ethnic undertones reflecting the dark side of human nature: e.g., biases against Jews in Europe, overseas Chinese in East Asia, Indians in East Africa, Ibos in West Africa, and people from the Middle East in Latin America. These biases also stem from the natural tendency to fear and dislike an activity, such as financial intermediation, that is poorly understood and, to some observers, mysterious (Hayak).

Until relatively recently, much of the research on informal finance was done in what was Colonial India or by sociologists and anthropologists. Studies by Darling and others in India in the early 1900s showed that informal lending provided most of the loans in rural areas and that the interest rates applied were often higher than those charged by banks in either India or the United Kingdom. Subsequent studies in India—especially the All-India-Rural Credit Surveys carried out each decade since the early 1950s—set the agenda for much of the later research and policy dialogue on informal finance in other regions. This agenda was generally negative in tone and stressed documenting the relative importance of informal finance, the extent of monopoly profits in these transactions, how loans linked to other marketing activities boosted profits, and the extent to which informal lending was used to appropriate land pledged as collateral (e.g., Ghose, Wai).

I am uneasy with this stereotyping and with the associated research. Instead, I feel there are important lessons to be learned from more objective study of informal finance--lessons that will be overlooked as long as we insist on chasing bogeymen in research on informal finance. Taking a fresh look at informal finance should involve studying the services provided along with the associated techniques, practices, and technologies used. Careful analysis of informal finance may also provide clearer insights into the types of financial services individuals and firms find to be most useful.

Types of Informal Finance

Finance exists because of heterogeneity among firms and individuals and because of the specialization and trade that ensues from these differences. This, in turn, results in a variety of financial needs which are partly met by a multiplicity of informal arrangements. While the stereotyped moneylender receives most of the publicity, a large variety of other arrangements handle most informal financial transaction in LICs. Some of these arrangements are centuries old, while other systems of informal finance are constantly evolving as the contours of the society and the economy change. The kaleidoscope of arrangements defies simple classification, and it is unusual to find a substantial number of these arrangements that are identical--a testimony to the flexibility and creativity involved in informal finance. For purposes of illustrating the variety found in these systems I briefly describe ten types of informal finance. Although I treat these ten types separately, it is common for them to overlap and also to be intertwined with other production or marketing activities (Sanderatne).

Sophisticated but Unregulated Institutions

In several countries, including the Dominican Republic, Guatemala, and India, sophisticated financial institutions exist that are informal only in the sense that they are not regulated. These institutions act like commercial banks and are often located in banklike offices that appeal to middle- and upper-class clients. They exist primarily to avoid taxes or regulations. In some cases they may be affiliated with banks through joint ownership or holding companies. Several recent studies suggest that these unregulated organizations charge reasonable interest rates and operate with modest transaction costs (Nayar, Vogel, Zinzer).

Moneylenders

Individuals who spend most of their time lending money—moneylenders—are significant sources of loans mainly in Asia. Typically, their loans are granted for short periods, are unsecured by collateral, and are extended to long-term clients. Most moneylenders operate on a small scale, extend loans mainly out of their own funds, and restrict lending to less than a hundred or so individuals. Moneylenders typically charge interest rates that are high relative to other lenders but extend loans quickly and impose few transaction costs on borrowers. These lenders operate in localized markets and often have highly personalized relationships with borrowers.

The main advantage moneylenders have over formal lenders is the comprehensive information they accumulate about their clients through day-to-day contact. Timberg and Aiyar found an extreme example of this when they asked an Indian moneylender how he decided to take on additional clients; he responded that he had never had a new client. Understandably, the proprietary nature of this information causes moneylenders, as well as other informal lenders who heavily rely on inside information, to be leery about sharing candid information about their operations with researchers (Chandavarkar).

Merchants

A closely related and much more common form of informal credit is provided by individuals who are primarily merchants but who also extend loans linked to the sale or purchase of commodities (Bardhan, Floro, Harriss, McLeod). Typically, lending is only a minor part of the merchant's activities, loans are repaid in relatively short periods of time, many of the loans carry no explicit interest charge, and the lender may adjust the price of the commodity involved in the transaction as compensation for the loan. Economies of scope are the main advantage that a merchant realizes in providing loans. Merchants can generally sell more fertilizer or purchase more rice, for example, if they also offer loans to their customers. Like the moneylender, merchants have the advantage of possessing inexpensive information about the borrower that is accumulated through purchases and sales of commodities. Under normal conditions the volume of loans provided by merchants increases as commercialization expands.

Some itinerant peddlers also provide small short-term loans to customers. In the Philippines, peddlers--often called Bombaies--sell items as diverse as umbrellas, electric fans, cosmetics, and clothing door-to-door in rural areas. They often make their village rounds on a daily or weekly basis to sell goods, take orders, and collect installment payments on previous purchases. Fruin reported similar services provided in rural areas of Indonesia during the 1930s by "installment chinamen."

Pawnbrokers

Still another form of informal finance is pawning, one of the oldest forms of lending. Some pawnbrokers work full-time at this occupation, whereas others pursue it as a sideline to money lending or marketing. In several countries, Indonesia and Sri Lanka, for example, some pawnshops are affiliated with banks.

Distinctive features of pawnshops are that they typically make small loans for short periods and resolve the loan collateralization problem inexpensively by requiring borrowers to exchange collateral physically for loans (Lamberte). Unlike banks, moneylenders, and traders, pawnbrokers need almost no information about their borrowers unless they are wary about receiving stolen goods. The pawnbroker realizes revenue from interest on loans and from the difference between loan amounts and sales receipts from items received as security on defaulted loans. Contrary to conventional wisdom, Bouman and Houtman argue that most pawnbrokers prefer to have individuals redeem the items they pawn, as this improves the chances of their continuing as clients.

Some individuals in the Philippines make their living primarily by conducting informal pawning operations combined with peddling items door-to-door that are not redeemed. These individuals may have loose working relationships with formal pawnshops or with relatively wealthy people who occasionally provide them operating capital. They may also combine their pawning activities with selling nonpawned goods door-to-door and offering installment arrangements on these sales (Adams and Sandoval).

Loan Brokers

Another type of informal finance is carried out by loan brokers who facilitate contacts among people with money to lend and borrowers by trading on inside information about potential clients. Typically, loans handled by brokers are relatively large and for a longer term than are most informal loans. Virtually anyone can enter the business who is able to assemble information about potential clients. Because borrowers of these brokered loans often do not qualify for additional bank credit, interest rates applied to these loans may be relatively high. As Larson points out, some of the lenders in Bolivia insist on collateral such as real estate before making a brokered loan. The broker is usually not a principal in the transaction but merely arranges contacts between lenders and borrowers. Some brokers may also provide collection or guarantee services and thus become more like principals than agents.

A different form of loan broker operates widely in rural areas of Bangladesh. These brokers obtain loan application forms from banks, help illiterate people fill them out, obtain necessary signatures and guarantees, and also allocate bribes necessary to overcome barriers to borrowing (Maloney and Ahmed). The broker is commonly rewarded through a share of the bribe or a share of the loan and acts as a legal buffer between the payer and receiver of the bribe.

Landlords

Although the practice is less common now than previously, some landowners still provide their tenants with loans. The main reason for this is scope economies. These loans facilitate access to labor and entrepreneurial skills that might otherwise be difficult to employ or manage. Typically, landlord lending declines in relative importance with land reform and with the expansion of other types of formal and informal finance (Sacay, Agabin, and Tanchoco).

A variant of this occurs when landowners who borrow money transfer to a lender usufruct rights over land, orchards, or fishing facilities for a time until loans are repaid. This arrangement is common in the highlands of Ecuador and among cacao farmers in Ghana (Adejeboye). It is also increasingly found in the Philippines, where farmers may pawn the title to some of their land and transfer use rights to the lender for a time to obtain relatively large loans to finance employment abroad by a family member.

Friends and Relatives

Perhaps the most common form of informal finance, both in terms of number and value of transactions, is loans from friends and relatives. In some countries these credits make up half or more of all informal loans. Many of these loans involve no interest or collateral, they may be large or small, and many have open-ended repayment arrangements. The most important feature of many of these loans is reciprocity: the expectation that the borrower is willing to provide a loan to the lender sometime in the future (Platteau and Abraham). In cases where the individuals involved have scant access to other forms of finance, the reciprocity may be an important way of managing uncertainty and risk through establishing and strengthening interpersonal ties.

Money Guards

Another form of informal finance is the money guard, a responsible person who agrees to safeguard cash for individuals. Graham and others report finding money guards in Niger, Maloney and Ahmed also found them in Bangladesh, and Bouman and Houtman report similar arrangements in India. Almost the entire reason for money guards is that they offer a secure place to deposit funds. In most cases these deposits earn no interest, although money guards may give depositors token favors or gifts. There are no restrictions on the uses money guards may make of deposited funds. In some cases depositors feel guards are doing them a favor by holding their money, and the amount of money deposited by each individual is usually small.

Nonrotating Savings and Credit Groups

Another important form of informal finance is nonrotating savings and credit groups. These consist of individuals who either regularly or irregularly, deposit funds with a group leader (e.g., Begashaw; Maloney and Ahmed). In most cases these groups are formed spontaneously, but in Thailand a government agency--the Community Development Department--plays a role in organizing such groups. The main problem these groups resolve is the pooling of savings, and it is not uncommon for these mobilized funds to be deposited in banks. While these groups may collect funds regularly, they do not distribute them among members through any systematic rotation. These groups are part of a larger class of informal groups that pursue a variety of purposes ranging from conducting financial intermediation to taxing group members to improve public facilities.

Some groups periodically collect funds from members and then return the amounts deposited to savers at the end of a given period; these are essentially contractual savings programs. Instead of returning contributions to members, other groups use money collected as emergency loan funds. Group members are essentially building reciprocal credit possibilities through their deposits. In other cases, the funds collected may be used to invest in enterprises that are administered by the group. Some groups are managed by commission agents, while others are run by volunteer leaders. Various forms of these groups can be found in most low-income nations, but they are especially important in Africa and in Islamic countries.

ROSCAS

A more complicated form of group finance is called rotating savings and credit associations (ROSCAS). They are found in many LICs and have been extensively studied, especially by sociologists and anthropologists (Bouman). In a number of areas more individuals participate in ROSCAS than have dealings with formal financial institutions, and large amounts of money may be involved (Adams and Canavesi). Recent research by Schrieder in Cameroon suggested the volume of deposits moving through ROSCAS there may be larger than the amounts held in banks. In some countries, especially among ethnic minorities, ROSCAS are a primary way of raising funds to make large business investments (Barton, Wu).

These associations are particularly interesting because they explicitly pool savings and tie loans to deposits. ROSCAS also resolve the loan collateral and borrower information problems by enrolling only members who have mutual confidence in each other or by having organizers who guarantee the performance of individuals they enroll. Loan recovery is seldom a problem in ROSCAS because a defaulting member not only loses the opportunity to remain in the association but may also be shunned and experience the loss of social and business ties that accompany membership (Velez-Ibanez).

It is surprising how often ROSCAS are found among employees of formal financial intermediaries. Many of the workers in the National Credit Union Federation in Chocabamba, Bolivia, for example, are members of ROSCAS (pasanakus). People working for the Development Finance Corporations in both Belize and St. Kitts/Nevis regularly participate in ROSCAS (syndicates and partners). Numerous employees of commercial banks and central banks in Belize and Bolivia are also ROSCA members. These associations likewise operate among employees of the Central Banks of the Dominican Republic (sans) and the Philippines (paluwagans). In 1987 there was even a ROSCA operating among employees of the International Monetary Fund in Washington, DC, all of whom had doctoral degrees in economics or finance!

The Case Against Exploitation

Critics most often cite exorbitant interest rates as the main justification for condemning informal finance. Cases of lenders charging 10 percent per day on loans, for example, are cited and then generalized as being representative of exploitation and proof of monopoly power. Also cited and generalized are horror stories about diabolical moneylenders or merchants who, in order to capture the borrower's collateral, extend loans to individuals whom lenders know will be unable to repay, debts that are inherited by the borrower's children, landlords who tie their tenants to land through debt at the company store, and merchants who link loans to repayment in kind and force borrowers to repay with products that are grossly underpriced (Basu, Bhaduri). These horror stories illustrate situations that are only possible when the lender exercises a large measure of monopoly power. Also, they report one-time operations that normally do not make economic sense for lenders who benefit from sustained relationships with their clients.

These blanket indictments, moreover, ignore the large number of informal loans made at modest interest rates, the multitude of loans made and repaid without the lender foreclosing on collateral, and the complexities involved in loans tied to marketing and production. They also ignore the extensive deposit mobilization that occurs in these markets, the multitude of informal loans made with no collateral involved, and the large number of people who pay high interest rates on their loans but realize even higher rates of return on investments made with borrowed funds. Critics also fail to mention that moneylenders may make only a few loans at extremely high interest rates, that these credits are often unsecured, and that borrowers paying the highest rates have low credit ratings. Critics also ignore inflation. In the mid-1980s informal lenders in Bolivia would have lost purchasing power on their loans if they had only charged 10 percent per week while inflation roared along at a rate of several thousand percent per year.

It is also important to remember that many of the loans with so called usurious interest rates are small and are for very short periods. It is common in Latin America, for example, for street vendors to borrow occasionally in the morning enough funds to cover their sales for the day and then to repay loans in the evening. A typical loan may be for only ten dollars and require repayment of eleven dollars, an annual interest rate of over 3,000 percent. At the same time, the loan may allow the vendor to realize daily earnings that are several times the value of the loan. It is unlikely that moralists would be upset with a merchant who each day sold the same kind of merchandise to a vendor but added a markup of 10 percent to the price of the good, a transaction that did not involve a loan.

At least three questions must be answered to establish whether lenders are taking undue advantage of borrowers: (1) What are a lender's opportunity costs of funds and the risks involved in lending? (2) Are most informal lenders in a position to extract monopoly profits? And (3) are credit transactions linked with marketing and production to enhance exploitation?

<u>Opportunity Costs and Risk</u>

Much has been asserted about the ubiquitous monopoly power of moneylenders, but little proof has been presented to support this allegation.

Studies by Singh and Harriss of moneylenders in India, along with a similar study by Wilmington in the Sudan, show that moneylenders' interest rates are high because the opportunity costs of funds together with lending risks are high. These researchers argue that it is unreasonable to expect moneylenders to charge borrowers less than the rate of return lenders could realize on alternative investments and that many moneylenders have business alternatives that yield high marginal returns. The high interest rates in informal markets may largely indicate that funds are scarce and that at least some people realize high rates of return from using borrowed funds.

Christen makes the same point from the perspective of borrowers in Latin America. He argues that many managers of microenterprises borrow from moneylenders at high rates of interest because of the low transaction costs involved and the high quality and dependability of the informal financial services and also because high rates of return result from the use of borrowed funds. Many of these high return activities are also available to lenders and are further indications of high opportunity costs of lending.

In addition, because of the seasonality of agricultural production, informal lenders may find it impossible to keep all of their money lent during the entire year. This forces them to charge higher interest rates during the time their money is lent to make up for periods when some of their loanable funds are idle.

Monopoly Profits

Because of the lack of barriers to entry, the large number of forms of finance, and the large number of people who are willing to enter markets where high rates of return are realized, it is difficult to see how informal lenders can regularly extract substantial monopoly profits. All of the many forms of informal finance, as well as formal lenders, partially compete with each other. In addition, anyone with money or easily transferable resources can become a lender. Effectively, there are few barriers to entry into informal finance. Likewise, borrowers can compete with informal lenders through substitution of equity for debt, barter, and sale and repurchase of assets. For example, if farmers have been borrowing funds from moneylenders to pay cash rent on farm land, they can instead rent land on a share basis from landowners. Also, the reason people invented money is that it will substitute for so many other things, but the reverse is also true: many things are partial substitutes for money through barter. The conditions necessary to realize monopoly profits exist only with barriers to entry and a highly differentiated product, conditions seldom encountered in informal financial markets.

If traces of monopoly power exist in informal financial markets they can be moderated by expanding formal lending. To be fully effective, however, the expansion in formal finance must compete with those elements of the informal system that have little competition. An expansion of cheap formal loans that go largely to well-to-do individuals does not compete with informal lenders who are largely serving the poor (Gonzalez-Vega).

Loans Linked with Marketing

It is often difficult to establish clearly the charges that are applied to loans when the loan or the repayment are in kind, as is often the case with loans linked to marketing. For example, a merchant in Sudan may agree to lend a farmer two sacks of millet and require the repayment of three sacks at harvest time in only two months. On a commodity basis, this amounts to a monthly interest rate of 25 percent or an annual rate of 300 percent. On a financial basis, however, the rate is much lower, even ignoring inflation.

Usually, the market price of millet between harvests is significantly higher than the price during harvest. If the interharvest price ranged from 25 to 50 percent higher than harvest prices, the interest rate on the loan would range from 0 to 120 percent on an annual basis. When loan repayment is in kind, the merchant assumes all of the price risk, something that is of additional value to the borrower. If a merchant in fact consistently realizes a monopoly profit on his millet-credit transactions, the cause may be imperfections in the millet market rather than monopoly power exercised in credit transactions. The merchant may own the only truck in town that is needed to haul millet to central markets, but it is less likely that the merchant will be the only person in the area who has funds or resources to lend. If monopoly power lies in other markets linked to informal finance, that power will not be directly affected by finance activities or their regulation.

While I have not systematically studied linked credit transactions, I have talked with a large number of merchants in various countries who provide loans to some of their customers to facilitate purchases or sales of goods. I have yet to find a merchant who would not prefer cash transactions over those involving credit. This suggests to me that most merchants view lending as a necessary nuisance rather than as a way to sweat additional profits out of their clients.

Moneylenders as Hospitals

Some so-called malignant informal lenders are mainly involved in providing small, short-term loans that are seldom backed by collateral and that are made to individuals who often suffer economic reverses. It is this part of informal finance that is a lightning rod for criticism of informal finance in general.

Instead of stereotyping as evil the informal lenders who serve this difficult set of clients, it may be more useful to think of them metaphorically as hospitals. Many of the patients who go there are physically (financially) stressed. They lack sufficient knowledge (funds) to heal themselves. As a result of their visit, some of these patients are cured and never return to the hospital. The health of others is improved by their visit, but some of them must return periodically for additional treatments (loans) to sustain their well-being. A few patients may perish (default) after coming to the hospital because their illnesses were too far advanced, they had afflictions that could not be treated by medicine (loans), or they refused to follow prudent health practices (were inefficient or unlucky managers).

Continuing the metaphor, hospitals are the most expensive form of medical treatment (charge the highest interest rates) because they mostly handle patients who are seriously ill (have the lowest credit ratings). In times of plague or natural disaster, a higher proportion of the patients (borrowers) coming to the hospitals may expire (default) because the hospital staff cannot give them sufficient attention (loans) or because they cannot extend the treatment over a long enough period of time (roll over the debt). More of the patients may also pass away (default) because they arrive at the hospital in worse shape than is true in normal times. In addition, doctors (informal lenders) will make more mistakes in their treatments (loans) because they are also stressed by the disaster. Since hospital employees are susceptible to many of the ills suffered by their patients, some of the employees (informal lenders) contact diseases from their patients and become seriously ill and even expire (go bankrupt).

Blaming moneylenders for the financial difficulties encountered by a few of their borrowers is as illogical as condemning hospitals because they treat people who are ill and because some of their patients pass away.

Lessons from Informal Finance

Informal finance persists and often flourishes because it resolves important problems that are handled poorly or not at all by most formal financial systems. I see at least six important lessons in this.

Types of Services Provided

The variety of informal financial arrangements is evidence of the broad range of financial services demanded by people in low-income countries. It is surprising how different these services are from those emphasized in traditional formal credit programs. Deposits, small loans, and short-term loans make up a large majority of informal financial transactions--services that are almost always absent in traditional agricultural credit programs. I conclude that many traditional credit programs may be providing the wrong mix of financial services.

Process Based on Discipline

Informal finance almost always involves participants in orderly processes that result in increasingly disciplined behavior. Informal lenders must discipline themselves to save to accumulate funds to lend. They must further discipline themselves to collect sufficient information about prospective borrowers so their loans can be made on the basis of creditworthiness. Informal lenders typically learn to judge creditworthiness and mobilize deposits over many years and only survive in the business if they are successful in developing these skills. Because most informal lenders have equity interest in their loans, they look at credit as a privilege, not a right, and view lending as a serious transaction rather than as a game of passing out favors.[6]

Informal borrowers also learn discipline as they attempt to establish and expand their creditworthiness in the eyes of informal lenders or group members. Borrowers of informal loans must earn the privilege of borrowing through disciplined steps that may include saving before borrowing, repaying small loans before receiving larger loans, and always repaying obligations to sustain access to informal finance. The products of increased discipline are strong and dependable working relationships between lenders and borrowers. These working relationships are the foundation of stable, reliable, and sustainable financial markets.

All too often, traditional agricultural lending is a hurried event that ignores this important process of learning, testing, and discipline building. I conclude that formal lenders ought to spend more time learning how to make loans on the basis of creditworthiness and that more attention must be given to helping borrowers systematically build their creditworthiness before showering them with loans.

Savings

The large amounts of savings that surface in informal financial markets are an indication of substantial propensities to save voluntarily and also show the miserable failure of most formal financial systems to provide attractive deposit services. Rural banks and cooperatives that do not accept deposits, negative real rates of interest on many deposits, and cheap rediscounting

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[6]An informal lender, for example, would never think of passing out hundreds of loans in a day on an ad hoc basis as has been done in India through highly politicized "loan melas" (loan fairs). Nor would an informal lender ever consider dropping off hundreds of loans in remote villages via helicopters as was done in Nicaragua a few years ago.

facilities in most central banks have resulted in few formal deposits being mobilized. Although formal financial systems should have a natural comparative advantage in mobilizing voluntary deposits, they have been largely designed to dispense cheap funds provided by government and donors. I conclude that informal finance works well because it depends on voluntary savings (inside money), while formal finance often fails because it heavily relies on governments or donors for funds (outside money).

Reciprocity

Many forms of informal finance involve reciprocity: the direct tying of loans to deposits or one person lending to another with the understanding--ofttimes implied rather than explicitly stated--that the lender may someday need to reverse roles. These unutilized credit reserves are especially important for low-income people who face uncertain conditions. Seldom do traditional formal credit programs provide lines of credit or more than just a single loan during a given period--they do not provide emergency credit. I conclude that formal finance would be much more useful to many people in LICs if credit reserves were more readily available.

Financial Innovations

Informal finance is peppered with innovations that reduce transaction costs, especially for depositors and borrowers. It is surprising how quickly informal finance can innovate to accommodate changing conditions such as inflation, economic prosperity, or economic downturns. Flexibility and suppleness are hallmarks of informal finance. In contrast, much of the innovative energy in formal financial markets is directed at regulation avoidance, and formal finance is often too brittle and rigid to respond effectively when economic conditions change.

I conclude from this that managers of formal financial institutions ought to be more observant of innovations and changes in informal finance and try to emulate many of these innovations.

Transaction Costs

A major achievement of informal finance is keeping the transaction costs of borrowers and savers low by bringing financial services to places and at times that are convenient to clients. In contrast, formal finance focuses mainly on reducing the transaction costs of the financial intermediary with little concern given to how this affects depositors and borrowers. With rare exceptions, clients of formal financial intermediaries must make deposits and seek loans on the premises of the intermediary at times that may or may not be convenient to clients.

The sharp differences in the distribution of transaction costs among participants in formal and informal financial markets are excellent proxies for the basic orientation of principal actors in these two markets. Formal intermediaries are mainly concerned with cultivating their major sources of funds: government officials, central bank employees, and donor employees; borrowers or depositors of small amounts are often treated as if they were pests. Informal intermediaries, in contrast, are almost entirely concerned about sustaining quality relationships with their borrowers or depositors.

I conclude from this that formal lenders must pay much more attention to reducing the transaction costs of borrowers and depositors and that they will likely not do this until large amounts of outside money are no longer available to them.

Concluding Remarks

Sustainable financial markets that operate efficiently and equitably are vital ingredients in rural development. The results of many formal agricultural credit programs in LICs over the past 30 years have been disappointing, and informal finance appears to be doing a better job of servicing the financial needs of many people in these countries than do these formal efforts. I don't want to be misinterpreted as arguing that formal financial arrangements are unnecessary and that informal finance is sufficient to support development; informal lenders are not the equivalent of the "noble savage." An efficient formal system is clearly necessary to intermediate over large distances, to efficiently manage large amounts of deposits, to make large loans, and to make long-term loans.

My main contention is that instead of trying to abolish informal financial arrangements, policy makers would be better advised to learn from them. Studying these markets will help to clarify the financial services that informal finance is providing more efficiently than formal intermediaries and may also uncover practices that could be adopted by banks and cooperative that are providing financial services. Giving three cheers for the informal lender is far more in order than trying to drive them out of business.

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